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ORIGINAL

Application of

Total Environmental Solutions, Inc.

For Approval of an Adjustment in Rates and Charges for Water and Sewer Services

Hearing Date: August 4, 2004

Docket No. 20034-90-W/S

Direct Testimony of
Sharon G. Scott
Audit Department

Public Service Commission of South Carolina

RETURN DATE: OK RNG
SERVICE: OK RNG

TESTIMONY OF SHARON G. SCOTT

FOR

THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NO. 2004-90-W/S

IN RE: TOTAL ENVIRONMENTAL SOLUTIONS, INC.

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Sharon G. Scott. My business address is 101 Executive Center Drive, Columbia, South Carolina. I am an Auditor for the Public Service Commission of South Carolina.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND YOUR BUSINESS EXPERIENCE.

A. I received a B.S. Degree in Business Administration, with a major in Accounting from the University of South Carolina in May 1983 and a MBA degree from Webster University in May 2000. I was employed by this Commission in July 1983, and have participated in cases involving gas, electric, telephone, and water and wastewater utilities. I have over 21 years of auditing experience with this Commission.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY INVOLVING TOTAL ENVIRONMENTAL SOLUTIONS, INC.?

A. The purpose of my testimony is to set forth, in summary form, the Staff's findings and recommendations resulting from our review of the Company's application in this docket. These findings and recommendations are set forth below and in the report of the Audit Department with attached exhibits.

Q. I SHOW YOU THIS DOCUMENT. WOULD YOU IDENTIFY IT PLEASE?

A. This is the "Public Service Commission of South Carolina, Commission Staff Report, Total Environmental Solutions, Inc., Docket No. 2004-90-W/S - Application for Rate Increase."

Q. DID YOU PREPARE, OR CAUSE TO BE PREPARED UNDER YOUR DIRECTION AND SUPERVISION, A PORTION OF THIS DOCUMENT?

A. Yes, with the exception of that portion which is tabbed Utilities Department, I prepared the report with assistance from the Audit Department Staff.

Q. (MARK FOR IDENTIFICATION). PLEASE EXPLAIN THE CONTENTS OF THIS REPORT.

A. As outlined in the Index of Staff's report, the first 5 pages contain the report analysis. The remaining pages consist of exhibits which were prepared to show various aspects of the Company's operations and financial position. The major portion of my testimony will refer to Audit Exhibit AC - Operating Experience and Operating Margin – Combined shown on page 6, Audit Exhibit AW- Operating Experience and Operating Margin – Water shown on page 7, and Audit Exhibit AS - Operating Experience and Operating Margin - Sewer shown on page 8. Staff prepared these exhibits in compliance with the Commission's standard procedures for Water and Wastewater utility rate increases.

Q. PLEASE EXPLAIN THE FORMAT OF AUDIT EXHIBITS AC, AW AND AS.

A. Column (1) shows the Company's per book balances as of December 31, 2002. Staff verified the per book balances to the Company's books and records.

Column (2) shows the Staff's accounting and pro forma adjustments designed to normalize the Company's per book operations.

Column (3) shows Staff's computation of the Company's normalized test year prior to giving effect for the proposed increase.

Column (4) shows the Staff's adjustments for the proposed increase as furnished by the Utilities Department and the adjustments associated with the additional revenue.

Column (5) shows the Staff's computation of the normalized test year after the accounting and pro forma adjustments and the effect of the proposed increase and its associated adjustments.

Q. PLEASE ELABORATE ON THE CALCULATIONS IN AUDIT EXHIBIT AC - OPERATING EXPERIENCE AND OPERATING MARGIN - COMBINED.

A. Shown in column (1) is the per book operating experience of the Company's combined operations. Staff computed Total Income (Loss) for Return of ($125,799) based on Total Operating Revenues of $211,044 less Total Operating Expenses of $336,843. The Staff did not include Customer Growth since 2003 year-end customers were used to annualize revenues. Total Income (Loss) for Return of ($125,799) and Total Operating Revenues of $211,044 produced an Operating

Margin of (59.61%). In column (2), Staff's accounting and pro forma adjustments are presented to normalize the Company's test year operations. A description of each adjustment is contained in Audit Exhibit A-1. Column (3) reflects the as adjusted figures. The accounting and pro forma adjustments for combined operations resulted in Total Income (Loss) for Return of ($134,384). The Operating Margin changed from (59.61%) to (53.13%). Column (4) shows the effect of the proposed increase for combined operations as computed by the Utilities and Audit Departments. These adjustments are detailed in Audit Exhibit A-1 of the report and are labeled for the Proposed Increase. Column (5) shows per book operations as adjusted to normalize the test year and after the proposed increase is added to as adjusted revenues for combined operations. Using Total Income for Return of $250,973 and Total Operating Revenue of $791,414, Staff computed an Operating Margin of 31.71%. The Staff did not include Interest Expense in the computation of the Operating Margin since the Company has a negative Rate Base.

Q. PLEASE ELABORATE ON THE CALCULATIONS IN AUDIT EXHIBIT AW- OPERATING EXPERIENCE AND OPERATING MARGIN - WATER.

A. Shown in column (1) is the per book operating experience of the Company's water operations. Staff computed Total Income (Loss) for Return of ($115,324) based on Total Operating Revenues of $76,194 less Total Operating Expenses of $191,518. The Staff did not include Customer Growth since 2003 year-end customers were used to annualize revenues. Total Income (Loss) for Return of ($115,324) and Total Operating Revenues of $76,194 produced an Operating Margin of (151.36%). In column (2), Staff's accounting and pro forma adjustments are presented to normalize the Company's test year operations. A description of each adjustment is contained in Audit Exhibit A-1. Column (3) reflects the as adjusted figures. The accounting and pro forma adjustments for water rates increased Total Income (Loss) for Return to ($126,480). The Operating Margin changed from (151.36%) to (116.82%). Column (4) shows the effect of the proposed increase for water operations as computed by the Utilities and Audit Departments. These adjustments are detailed in Audit Exhibit A-1 of the report and are labeled Proposed Increase. Column (5) shows per book operations as adjusted to normalize the test year and after the proposed increase is added to as adjusted revenues for water operations. Using Total Income for Return of $119,077 and Total Operating Revenue of $426,929, Staff computed an Operating Margin of 27.89%. The Staff did not include Interest Expense in the computation of the Operating Margin since the Company has a negative Rate Base.

Q. PLEASE ELABORATE ON THE CALCULATIONS IN AUDIT EXHIBIT AS - OPERATING EXPERIENCE AND OPERATING MARGIN - SEWER.

A. Shown in column (1) is the per book operating experience of the Company's sewer operations. Staff computed Total Income (Loss) for Return of ($10,475) based on Total Operating Revenues of $134,850 less Total Operating Expenses of $145,325. The Staff did not include Customer Growth since 2003 year-end customers were used to annualize revenues. Total Income (Loss) for Return of ($10,475) and Total Operating Revenues of $134,850 produced an Operating Margin of (7.77%). In column (2), Staff's accounting and pro forma adjustments are presented to normalize the Company's test year operations. A description of each adjustment is contained in Audit Exhibit A-1. Column (3) reflects the as adjusted figures. The accounting and pro forma adjustments for sewer operations resulted in Total Income (Loss) for Return of ($7,904). The Operating Margin changed from (7.77%) to (5.46%). Column (4) shows the effect of the proposed increase for sewer operations as computed by the Utilities and Audit Departments. These adjustments are detailed in Audit Exhibit A-1 of the report and are labeled Proposed Increase. Column (5) shows the per book operations as adjusted to normalize the test year and after the proposed increase is added to as adjusted revenues for sewer operations. Using Total Income (Loss) for Return of $131,896 and Total Operating Revenue of $364,485, Staff computed an Operating Margin of 36.19%. The Staff did not include Interest Expense in the computation of the Operating Margin since the Company has a negative Rate Base.

Q. PLEASE EXPLAIN THE ADJUSTMENTS IN AUDIT EXHIBIT A-1.

A. The adjustments are as follows:

Adjustment # 1 – The Company proposes to reflect revenues based on a bill frequency analysis using present rates. The Utilities Department proposes to adjust revenues using the number of customers at December 31, 2003 and the present rates. The As Adjusted Revenues computed by the Utilities Staff totaled $249,943 - combined, $105,958 - water, and $143,985 - sewer. These amounts less the per book amounts of $199,242 - combined, $67,964 - water, and $131,278- sewer resulted in an adjustment of $50,701 - combined, $37,994 - water, and $12,707 - sewer.

Adjustment # 2 – The Company proposes to reflect revenues for customers gained during 2003. Since the Utilities Department Staff annualized revenues based on 2003 year-end customers, the Staff has already taken into consideration the growth in number of customers. Therefore, no customer growth adjustment is made since the revenues are based on 2003 year-end customers.

Adjustment # 3 – The Company proposes to reflect revenues for customers previously not being billed. The Staff did not make this adjustment since it annualized revenues based on 2003 year-end customers. These customers are included in the 2003 year-end customer count.

Adjustment # 4 – The Company proposes to reflect additional revenues for new taps. The Staff proposes to remove these tap fees from revenues. For ratemaking purposes, these amounts are considered contributions in aid of construction and a reduction to the Company's rate base. The Staff proposes to remove total tap fees collected in the test year of $5,600 (combined), $2,700 (water), and $2,900 (sewer).

Adjustment # 5 – The Staff proposes to remove the South Carolina Department of Health and Environmental Control's (SCDHEC) fees and costs associated with the Safe Drinking Water Act from revenue and expenses. The Company is allowed to pass these costs through to the customer as a separate charge. These fees and costs, totaling $3,221 for revenue and $2,989 for expenses, are eliminated since they are not regulated by this Commission.

Adjustment # 6 – The Staff and Company propose to annualize direct wages and benefits for South Carolina employees. The Staff annualized wages using the most current hourly rate at May 2004. Staff annualized the wages for three (3) employees whereas the Company used four (4) employees. Staff found that one employee, a Field Technician, no longer works for the Company and has not been replaced. The average overtime hours were computed using actual overtime hours for 2002, 2003, and annualized hours for 2004 applied to the most recent pay rates as of May 2004. Staff also computed FICA, FICA Medical, State Unemployment and Federal Unemployment Taxes on these wages. Dental, Health, Life Insurance and Retirement expenses were also annualized using the most current rates as of April 2004. Total salaries and benefits amounted to $93,682 for water and sewer operations. This amount was allocated to water and sewer based on the number of customers, resulting in an assignment of 51% to water and 49% to sewer, $47,778 and $45,904 respectively. These amounts are netted against the per book amounts of $47,281 (combined), $28,854 (water) and $18,427 (sewer) for adjustments of $46,401 (combined), $18,924 (water), and $27,477 (sewer). The Staff did not allocate a portion of the wages to the Lockhart operations since the Lockhart operation is maintained by contract employees which are not employees of TESI. The differences in the Staff's and Company's adjustment arise due to differences in the hourly rates, average overtime, number of employees, and allocations to the Lockhart system.

Adjustment # 7 – The Company proposes to adjust expenses to reflect an increase in purchased water costs. Staff reviewed the adjustment and found that the increase was based on water usage only and that no actual increase in the water rates charged by the Westminster Commission of Public Works occurred in 2002 or 2003. Therefore, Staff does not propose to make this adjustment since the water usage can fluctuate and the usage is not known and measurable.

Adjustment # 8 – The Company originally proposed to reflect an increase in purchased power costs for booster stations. However, the booster stations were not purchased and therefore this adjustment should be eliminated. The Company informed Staff during its audit of these circumstances. Therefore, the Staff does not propose to make this adjustment.

Adjustment # 9 – The Staff and Company propose to remove Contract Operation Expenses from operating expenses. The Company's employees began performing this work in 2003. The expenses included daily operation of the wastewater treatment plant, lab work, sampling, monthly reports, and other contract work for sewer operations. For water operations, the expenses included contract work to repair leaks and broken water lines. The removal of these expenses eliminated the total per book amounts for Contract-Operations Expenses of $2,405 for water, $41,427 for sewer and $43,832 for combined operations.

Adjustment # 10 - The Staff and Company propose to adjust for the increase in insurance premiums for Auto, General Liability, Excess (Umbrella) Liability, Property and Casualty, Pollution Coverage and Workers' Compensation. The premiums cover the period from December 2003 through December 2004. The 2004 premiums were verified to the insurance company invoices. The vehicle insurance allocation was based on the use of 2 cars (total Company fleet of 90 cars) in South

Carolina. South Carolina's portion amounted to $4,757. This amount was allocated 51% ($2,426) to water and 49% ($2,331) to sewer based on the number of water and sewer customers. None of these vehicle insurance expenses was allocated to Lockhart since it is a contract system. The General Liability Insurance Allocation, which includes the Excess Liability (Umbrella Insurance), Property & Casualty, Pollution Coverage and General Liability, was based on customer counts at December 31, 2002. South Carolina's customers totaled 1,721 of the total company usage customers of 29,516. The Staff also reduced the premium by a portion allocated to the corporate office. South Carolina was allocated $14,018. Staff then allocated this amount between the Mountain Bay water and sewer systems, and the Lockhart system based on customer counts of 517 ($4,211) for Mountain Bay water, 504 ($4,105) for Mountain Bay sewer, and 700 ($5,702) for the Lockhart system. The General Liability adjustment was applied to the Lockhart system which is owned by the Company and serves 700 customers even though it is basically considered one contract customer to the Company. Staff allocated the Workers' Compensation insurance based on the 2001 premiums from the Workers' Compensation audit, which was the last audit performed. South Carolina's premiums from the study amounted to $583 of the total company amount of $81,682, producing an allocation factor of .71374%. This factor was applied to the total Workers' Compensation 2004 premium of $152,899, resulting in an allocation to South Carolina of $1,092 ($553 for water and $539 for sewer). No Workers' Compensation Insurance expenses were allocated to the Lockhart system since the system is operated by contract employees.

The total adjustment amounted to $7,190 for water, $6,975 for sewer, and $14,165 for combined operations. The Company's adjustment was based on estimated premiums for 2004 and the Company's premiums were allocated 50% to water, 49% to sewer, and 1% to the Lockhart operations.

Adjustment # 11 – The Staff and Company propose to include the allocation of affiliated services expenses for the corporate office located in Baton Rouge, Louisiana and for the parent Company, South Louisiana Electric Cooperative Association (SLECA). The adjustment is based on information from the Company's Affiliated Services Charges Study as of December 31, 2002. The Staff verified a sample of the corporate expenses to invoices, verified allocations, and recalculated the schedules found in the study. The adjustment covered expenses from the following areas: Debt Service and Facilities Costs, Operating Capital Costs and Expenses, Professional Services, Parent Company Charges and Salaries, Wages and Benefits. Staff made all allocations to South Carolina based on the number of customers for water (517) and sewer (504) in proportion to the total amount of customers per the Company's Affiliated Services Charges Study, excluding Lockhart. The resulting factors were 1.23% to water and 1.20% to sewer. The allocations exclude the South Carolina Lockhart system since it is a contract customer, with very little to no work done on this system by the corporate office.

The Company proposes to include total Annual Debt Services costs of $32,142 and total facilities costs of $21,127. The Company included a 20% coverage factor for annual debt service and a 5% coverage factor for facilities costs, for a total amount of $53,269. Of this amount, $1,582 was allocated to South Carolina's Mountain Bay water and sewer systems. The Staff's adjustment removed the debt service costs, which is interest expense on the note for the corporate office, because the Company had a negative rate base. The Staff did not include a coverage charge for any of the Company's facilities costs since this amount was included by the Company as a margin to cover unexpected costs and cash flow requirements. Such amounts are not known and measurable and should not be included for ratemaking purposes. The Staff verified the facilities operating expenses to paid invoices. The Staff proposes to allow a total amount of $18,105 with $440 allocated to the South Carolina Mountain Bay water and sewer systems to cover facilities operating expenses.

Additionally, the Company proposed to include corporate office operating costs and expenses totaling $694,353, which included a 5% coverage charge, with $27,771 being allocated to South Carolina for the Mountain Bay water and sewer systems. The Staff excluded the 5% coverage charge because it is not a known and measurable expense. The Staff also eliminated depreciation expense because the Company has a negative rate base. Staff's total expenses amounted to $634,538 with $15,419 being allocated to South Carolina Mountain Bay water and sewer systems.

The Company's total expenses for corporate office salaries, wages, and benefits amounted to $722,280, which included a 5% coverage amount, with $27,897 being allocated to the South Carolina Mountain Bay water and sewer systems. The Staff did not include the 5% coverage amount because it is not known and measurable. The Staff recomputed corporate office wages and benefits using payroll hourly rates as of May 2004. Staff eliminated the corporate office employees which had been terminated in 2002 and allowed for a 3% pay increase received by salaried employees. Staff's total Company corporate office salaries, wages, and benefits amounted to $867,012, with $16,242 for wages and salaries, $1,369 for payroll taxes, and $1,943 for employee benefits allocated to South Carolina's Mountain Bay water and sewer systems. The total salaries and wages, payroll taxes and benefits allocated to South Carolina Mountain Bay systems amounted to $19,554.

The Staff's total corporate office adjustment, allocated to South Carolina-Mountain Bay water and sewer systems, amounted to General and Administrative Expenses of $34,044 (water of $17,233 and sewer of $16,811) and Taxes Other Than Income of $1,369 (water of $693 and sewer of $676). The Company's total adjustment, allocated to South Carolina Mountain Bay water and sewer systems, amounted to General and Administrative Expenses of $52,565 (water of $26,547 and sewer of $26,018), Depreciation and Amortization of $2,737 (water of $1,384 and sewer of $1,353) and Taxes Other Than Income of $1,948 (water of $984 and sewer of $964).

<u>Adjustment # 12</u>– The Staff and Company propose to adjust for rate case expenses associated with this filing. The Company estimated expenses of $120,000 for water and $120,000 for sewer and proposed to amortize these amounts over a 3-year

period. The Company's per book amounts of $10,205 for water and $8,605 for sewer were subtracted from the $40,000 water amortization and the $40,000 sewer amortization, resulting in adjustments of $29,795 for water, $31,395 for sewer and $61,190 for combined operations. The Staff's adjustment is based on actual expenses verified to May 2004. The invoices were reviewed by Staff and total rate case expenses amounted to $106,828 for water and $29,882 for sewer, combined for a total of $136,710. The Utility's last rate case proceeding was in 1993, eleven (11) years ago. However, the Staff proposes to use a more reasonable amortization period of 5 years. The Staff amortized $106,828 over 5 years or $21,366 per year for water less the Staff verified per book amount of $8,117 and included an adjustment of $13,249. The Staff amortized $29,882 over 5 years or $5,976 per year for sewer less the Staff verified per book amount of $5,230 and included an adjustment of $746. The Combined adjustment amounted to $13,995.

Adjustment # 13 – The Staff and Company propose to adjust Depreciation Expense. The Company proposes to include Depreciation Expense for the original plant in service and for plant additions. The original cost of Plant in Service was developed from the Company's Depreciation Cost Study. The adjustment also included 2003 plant additions. The Company's adjustment amounted to $38,308 for water, $63,393 for sewer and $101,701 for combined operations. Staff calculated that the Company would have a total rate base of $817,943 based on the depreciation study conducted by the utility for this proceeding. However, the Staff did not use the study because TESI did not pay $817,943 for the utility. TESI purchased Mountain Bay and a number of other water and wastewater companies from a bankruptcy proceeding. TESI paid a total price of $3,450,000 to acquire the total systems from six (6) states. The Staff's adjustment allocated the purchase price to Mountain Bay based on the number of customers at December 31, 2002. The total number of customers in all the systems purchased was 42,624. Mountain Bay's customer base at December 31, 2002 was 1,021. Therefore, the Staff allocated 2.39536% or $82,640 of the purchase price to Mountain Bay. TESI made plant additions for 2001 and 2002 of $80,361 and plant additions for 2003 of $94,396 at Mountain Bay after they purchased the utility. The total purchase price plus plant additions resulted in Gross Plant in Service of $257,397. TESI has collected $351,456 in lot enhancement fees for 2002 and 2003 and $19,300 in tap fees from Mountain Bay's customers since it acquired the system. Tap fees and lot enhancement fees were treated by the Staff as being Contributions in Aid of Construction and accordingly they were treated as a reduction of the purchase price to TESI. The Staff calculated that TESI's original cost minus contributions in aid of construction and other rate base items would generate a negative rate base of ($61,980). The Staff did not allow depreciation expense or interest expense due to this negative rate base. However, if the Commission decided to use the rate base from the study, which has been reduced by net contributions in aid of construction, tap fees from inception of the system and plant enhancement fees since the last rate case, depreciation expense would be $15,160 and allowable Interest Expense would be $15,678. The resulting Operating Margins, which include Interest Expense, would be 25.40% for water, 33.80% for sewer, and 29.27% on a combined basis.

Adjustment # 14 – The Staff and Company propose to remove a nonallowable penalty of $4,900 paid to the South Carolina Department of Health and Environmental Control. The payment was for a civil penalty in reference to Consent Order #02-248-W, NPDES # SC0022357.

Adjustment # 15 – The Staff proposes to remove expenses which the Staff considers to be nonallowable for ratemaking purposes. These expenses include credit card penalties of $121, legal fees miscoded to the utility of $180, and a late payment fee for purchased water of $787.

Adjustment # 16 – The Staff and Company propose to reclassify property taxes that were incorrectly booked to the water system. The adjustment corrects the allocation between water and sewer.

Adjustment # 17 – The Staff and Company propose to adjust for the Gross Receipts Tax on present revenues. The Company used an assessment rate of .01324 for water operations and taxable revenues of $113,642. The Company computed an amount of $1,739 less the per book gross receipts of $1,613 for an adjustment of $126. The Company used a factor of .00696 for sewer operations and taxable revenues of $148,728. The Company computed an amount of $1,270 less the per book amount of $1,065 for an adjustment of $205. The combined adjustment amounted to total taxes of $3,009 less the per book amount of $2,678 for an adjustment of $331. The Staff used the most recent PSC assessment rate of .007110428 and its present revenues for water of $108,267 for a computed amount of $770 less the per book amount of $1,613, resulting in an adjustment of ($843). For sewer operations, Staff used present revenues of $144,657 and the gross receipts factor of .007110428 for a computed amount of $1,029 less the per book amount of $1,065 for an adjustment of ($36). The combined adjustment totaled $1,799 less the per book amount of $2,678 for an adjustment of ($879).

Adjustment #18 - The Company proposes to include Interest Expense as an above-the-line operating expense. The Staff does not consider Interest Expense as an operating expense, but includes Interest Expense, if applicable, when computing the Operating Margin. The Company has a negative rate base and therefore no Interest Expense was allowed by Staff.

Adjustment #19 – The Staff and Company propose to adjust revenues for the proposed increase. The Staff's proposed revenue adjustment amounted to $318,662 for water and $219,828 for sewer, for a combined adjustment of $538,490. The Company's proposed revenue adjustment amounted to $319,508 for water, $220,557 for sewer and $540,065 for combined operations.

Adjustment #20 - The Staff and Company propose to adjust for the Gross Receipts Tax on revenues after the proposed increase. The Company used an assessment rate of .01324 for water operations and taxable revenues of $433,150. The Company computed an amount of $5,970 less the as adjusted amount of $1,739 for an adjustment of $4,231. The Company used a factor of .00696 for sewer operations and its taxable revenues of $369,285. The Company computed the amount of $2,805 less the as adjusted amount of $1,270 for an adjustment of $1,535. The Staff used the most recent PSC assessment rate of .007110428 and its After the Proposed Revenue amount for water of $426,929 for a computed amount of $3,036 less the as adjusted amount of $770, resulting in an adjustment of $2,266. For sewer operations, Staff used the After the Proposed Increase Revenue of $364,485 and the gross receipts factor of .007110428 for a computed amount of $2,592 less the as adjusted amount of $1,029 for an adjustment of $1,563. The combined adjustment amounted to $3,829.

Adjustment # 21 – The Staff and Company propose to adjust income taxes for the effect of the proposed increase. The Company used its water taxable revenues of $433,150 and a state tax rate of 5.0% and a federal tax rate of 34%, resulting in an adjustment after expenses of $4,406 for state taxes and $28,460 for federal income taxes. The Company used its sewer taxable revenues of $369,285 and a state tax rate of 5.0% and a federal tax rate of 34%, resulting in an adjustment after expenses of $3,756 for state taxes and $24,264 for federal income taxes. The combined adjustment amounted to $32,866 for water, $28,020 for sewer, and total taxes of $60,886. The Staff used the After the Proposed Increase Revenues for water of $426,929 and sewer of $364,485 less operating expenses for taxable income. Staff used a 5% state tax rate and 34% federal tax rate resulting in an adjustment of $70,839 for water, $78,465 for sewer, and $149,304 for combined operations. See Audit Exhibit A-2 for Computation of Income Taxes for details.

Q. PLEASE DESCRIBE THE REMAINING AUDIT EXHIBITS.

A. Audit Exhibit A-2 shows the Computation of Income Taxes. Audit Exhibit A-3 shows the Income Statement for the Test Year Ended December 31, 2002. Audit Exhibit A-4 shows the Balance Sheet for the Test Year Ended December 31, 2002.

Q. WHAT ARE THE RESULTANT OPERATING MARGINS FROM THE RATES BEING REQUESTED IN THIS CASE?

A. The Staff computed an Operating Margin of 31.71% for combined operations, 27.89% for water operations, and 36.19% for sewer operations.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.